State of California
Franchise Tax Board

06.06.08

FTB NOTICE 2008 - 4

SUBJECT: Resolution of Bogus Optional Basis (BOB) Transactions and Certain Employee Stock Ownership Plan (ESOP) Transactions

## Section 1. Purpose of the Notice

The purpose of this Notice is to announce that the Franchise Tax Board (FTB) will permit taxpayers to resolve certain eligible transactions that may be subject to the noneconomic substance transaction (NEST) penalty under Revenue and Taxation Code (RTC) section 19774 by providing reduced penalties to participants. Section 2 of this Notice sets forth the period during which eligible participants must submit completed and signed closing agreements and applicable payments to the FTB. Section 3 describes which taxpayers are eligible to obtain resolution under this Notice. Section 4 describes the eligible transactions. Section 5 describes the terms of the resolution (including reduced penalties), and Section 6 provides the procedures for participation.

## Section 2. Participation Period

Eligible taxpayers have from June 23, 2008, until September 12, 2008, to submit closing agreements to the FTB to resolve the tax treatment of the eligible transaction(s), to pay all tax, interest and reduced penalties resulting from the concession of all previously claimed tax benefits pertaining to the eligible transaction(s), and to provide documents related to the eligible transaction(s).

## Section 3. Eligible Participants

Taxpayers who claimed state tax benefits on an original or amended return from an eligible transaction described in Section 4 may obtain resolution under this Notice. Taxpayers currently under examination by the FTB and/or the Internal Revenue Service (IRS) or in protest or appeal with the FTB regarding their participation in an eligible transaction may also obtain resolution under this Notice. Taxpayers who participated in a transaction that was eligible for resolution under California's Tax Shelter Resolution Initiative, FTB Notice 2006-1, which was limited to the 21 transactions identified in IRS Announcement 2005-80, 2005-2 C.B. 967, are not eligible to participate in the resolution described in this Notice.

Legal Division MS A260
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Taxpayers who entered into an eligible transaction prior to the date of this Notice, but have not yet realized the tax benefits from that transaction, are not eligible to participate in the resolution described in this Notice. These taxpayers should be aware that they will be subject to all applicable penalties if they file a return claiming the tax benefits of an eligible transaction at a later date and that all relevant statutes of limitations will apply, including the eight-year statute of limitations provided for in RTC section 19755.

## Section 4. Eligible Transactions

The following transactions are eligible for resolution under this Notice:

A. "BOB" Transactions. Transactions, or any part, step or intermediate transactions, that are the same as, or substantially similar to, transactions that add additional adjusted basis to appreciated assets held by a partnership, appreciated assets held by a partner(s), or appreciated partnership interests where (1) the partnership made elections under Internal Revenue Code (IRC) section 754 and adjusted the tax basis of any asset under IRC section 743 or section 734 so that the asset is depreciated or amortized using a higher adjusted basis or when the asset is sold, the original built-in-gain is deferred, offset, netted, and/or permanently eliminated; (2) the partnership or purchasing partner incurs or assumes a liability or other debt; (3) an event occurs which triggers an IRC section 743(b) adjustment, such as a sale or exchange of a partnership interest, or an IRC section 734(b) adjustment, such as a distribution of partnership property; and (4) there is a disparity between a partner's basis in his, her, or its interest in the partnership and his, her, or its proportionate share of the adjusted basis of the partnership's property. These transactions include any part or step in a transaction, plan or arrangement, that are the same as, or substantially similar to, transactions described in IRS Uniform Issue List (UIL) No. 9300.42-00. The transactions described in this paragraph may be referred to as "bogus optional basis" or "BOB" transactions.

B. ESOP Transactions. Transactions involving the use of employee stock ownership plans (ESOPs) that could be subject to a NEST penalty and were not eligible to participate in California's Tax Shelter Resolution Initiative, FTB Notice 2006-1. Three transactions involving ESOPs that were eligible under FTB Notice 2006-1 and that are not eligible under this Notice are: (1) transactions covered by Revenue Ruling 2003-6, 2003-1 C.B. 286; (2) transactions covered by Revenue Ruling 2004-4, 2004-1 C.B. 414; and (3) Management S corporation ESOP transactions described in the IRS's *Transaction-specific Frequently Asked Questions* released as part of IRS Announcement 2005-80, 2005-2 C.B. 967. The eligible transactions described in this paragraph may be referred to as "certain ESOP transactions."

   Transactions, or any part, step or intermediate transactions, that are the same as, or substantially similar to, the following: (1) an ESOP purchases or otherwise obtains, or purports to have obtained, shares of stock or other equity interests in an entity (ESOP Entity) that is or was owned by Taxpayer and/or one or more of its related parties, directly or indirectly, at any time (ESOP Equity Purchase); (2) in one or more of the

Taxable Years at Issue, fifty percent or more of the taxable income of the ESOP Entity is or was allocated, directly or indirectly, to the ESOP (ESOP Income Allocation); and/or (3) in one or more of the Taxable Years at Issue, Taxpayer recognized less taxable income from or attributable to (a) the ESOP Entity, and/or (b) the stock or other property transferred to the ESOP Entity than Taxpayer would have otherwise recognized without the ESOP Income Allocation.

One example of an eligible ESOP transaction is the following. Taxpayer A holds 100 percent of the outstanding stock of XYZ Corporation (an S corporation) on December 30, 2000. On December 31, 2000, Taxpayer A forms an ESOP. On January 1, 2001, Taxpayer A sells stock in XYZ Corporation to the ESOP. During tax years 2001 through 2004, Taxpayer A assigns income to XYZ Corporation or otherwise provides services through XYZ Corporation. All income earned or assigned to XYZ Corporation during tax years 2001 through 2004 is allocated to the ESOP. Prior to or on December 31, 2004, XYZ Corporation obligates itself to compensate Taxpayer A for prior services. Such obligation substantially reduces the fair market value of XYZ Corporation. Taxpayer A purchases one or more shares of XYZ Corporation stock from XYZ Corporation. XYZ Corporation repurchases the ESOP's shares of XYZ Corporation stock for substantially less than the fair market value of XYZ Corporation's assets due to its obligation to Taxpayer A. Taxpayer A again holds 100 percent of the outstanding stock of XYZ Corporation. Other variations of this transaction use different methods or obligations to reduce the value and/or increase the adjusted tax basis of XYZ Corporation or its outstanding stock.

## Section 5. Terms of Resolution

Eligible participants must submit a complete and signed closing agreement (FTB Notice 2008-4 Closing Agreement) to the FTB between June 23, 2008, and September 12, 2008, which concedes all claimed tax benefits, including any basis adjustments, relating to the eligible transaction(s). A closing agreement will not be considered complete unless it also includes each of the following schedules:

- Schedule I – transaction information and the identity of other parties to the transaction(s);
- Schedule II – information document requests for opinions and other matters regarding the promotion of the transaction(s);
- Schedule III – computation of the tax, penalties and interest relating to the resolved transaction(s). This schedule is in lieu of filing an amended return, which is not acceptable under this Notice.

A. <u>Participants who received a Notice of Proposed Assessment</u> - For a participant who received a Notice of Proposed Assessment (NPA) adjusting the tax benefits claimed from the eligible transaction(s) prior to the date of this Notice, the participant must pay the full amount of tax shown on the NPA relating to those adjustments, plus interest accrued up to the date of payment with the submission of the completed and signed closing agreement (FTB Notice 2008-4 Closing Agreement). In addition, if the

NPA included a 40% NEST penalty under RTC section 19774, the FTB's Chief Counsel will reduce the NEST penalty to 20% pursuant to his authority under RTC section 19774(d). Payment of the reduced NEST penalty must also accompany the closing agreement. Also, if the FTB assessed an RTC section 19777 100% interest-based penalty on the NPA, the FTB will abate that penalty if the assessment is not final.

If the FTB assessed a 40% NEST penalty that the participant paid prior to the date of this Notice, FTB's Chief Counsel will reduce the NEST penalty to 20%. The FTB will then refund any overpayment if the taxpayer fully complies with all of the requirements of this Notice and the amounts previously paid are within the applicable statute of limitations.

B. Participants who did not receive a Notice of Proposed Assessment - For a participant who has not received an NPA adjusting the tax benefits claimed from the eligible transaction(s) prior to the date of this Notice, the participant must pay the self-assessed tax shown on Schedule III to the FTB Notice 2008-4 Closing Agreement, a 20% accuracy-related penalty under RTC section 19164, and interest accrued up to the date of payment. The FTB will not assess an RTC section 19774 NEST penalty or an RTC section 19777 100% interest-based penalty in this situation.

C. For all participants - Eligible participants who fully comply with the requirements of this Notice will be relieved of other penalties assessable under the RTC relating to their participation in the eligible transaction(s), including penalties under RTC sections 19164(c), 19164.5, 19772, 19778 and former RTC section 19773.

Participants in the resolution described in this Notice are not entitled to any suspension of interest under RTC section 19116.

Eligible participants will not be allowed to treat as an ordinary loss, capital loss, deduction, expense, capitalized cost or addition to basis any fees or other amounts paid to promoters, material advisors, attorneys, accountants, appraisers or others to plan and carry out the transaction(s), including, but not limited to, accounting, legal, promotion, or spread commission fees, any account fees for opening, establishing or reactivating an account, any commissions, or any other transaction costs associated with the eligible transaction(s).

In addition, as an express condition of the resolution described in this Notice, no refund or credit of amounts paid in connection with the resolution described in this Notice will be allowed. Participants also waive any statutory right to appeal or otherwise contest the validity of the eligible transaction(s) resolved by the closing agreement or the amounts paid in connection with the closing agreement in any forum, whether administrative or judicial.

Eligible taxpayers who do not participate in the resolution described in this Notice or participants who fail to comply with all of the requirements of this Notice will be subject to all penalties otherwise applicable to that transaction. Taxpayers should be aware that under

RTC section 19755, the FTB has eight years after a taxpayer files a return to assess additional tax and penalties relating to an abusive tax avoidance transaction.

If the participant has other unreported income unrelated to the eligible transactions, applicable penalties may be imposed.

## Section 6. Procedures

Taxpayers who want to participate in the resolution described in this Notice and avail themselves of the penalty relief described herein must do all of the following:

A. Closing Agreement. Complete and sign the closing agreement (FTB Notice 2008-4 Closing Agreement) and submit it to the FTB by September 12, 2008. Pursuant to the terms of this resolution, the closing agreement shall provide that a participant specifically agrees to: (1) the disallowance of all claimed tax benefits associated with the eligible transaction(s), (2) the denial of any deduction for any transaction costs relating to the transaction(s), (3) no refund or credit of amounts paid under this Notice, and (4) the waiver of any rights to contest/appeal the validity of the transaction(s) resolved pursuant to the closing agreement. The closing agreement will also include provisions addressing the penalty relief described in this Notice. Except in the event of fraud, malfeasance, misrepresentation and/or omission of a material fact by a participant, an executed closing agreement cannot be reopened by the FTB. The closing agreements will permanently resolve all tax, penalties and interest associated with the taxpayer's participation in the eligible transaction(s). Subsequent federal adjustments with respect to the eligible transaction(s) will have no effect on the terms or finality of an executed closing agreement.

   Closing agreements and applicable schedules will be available upon request and online at www.ftb.ca.gov/law/notices.

   If the participant in the transaction(s) was a partnership, S corporation or other pass-through entity, then the person or entity that received the tax benefits from the participant should submit the completed and signed closing agreement. One closing agreement should be submitted per taxpayer.

B. Payment. Either submit with the completed and signed closing agreement payment in full of all taxes, interest and penalties due under the terms of the resolution described in this Notice or, if the taxpayer has a financial hardship, submit a request to enter into an installment payment arrangement with FTB to pay that amount over a period not to exceed 12 months. FTB will not execute a submitted closing agreement absent payment in full or the presence of an acceptable payment arrangement. FTB will verify the mathematical computation of the tax, penalty and interest and either bill the participant or refund any excess amount paid.

C. Required Information. Participants must complete in full Schedule I, submit all information required in Schedule II, compute additional tax, applicable penalties and interest on Schedule III, and provide upon request any other information necessary to determine the proper tax liabilities. The schedules are integral and essential components of a completed closing agreement. The FTB will not enter into a closing agreement with any participant without the participant completing in full Schedules I, II and III and submitting those schedules with the closing agreement to the FTB on or before the conclusion of the participation period on September 12, 2008.

D. Processing. After obtaining the necessary information, and receiving either payment of all taxes, interest and penalties due under the terms of this Notice or entering into a payment arrangement with FTB, the FTB will examine the information and documents provided in Schedules I and II and verify the calculations in Schedule III. After the closing agreement(s) have been accepted as accurate and complete by FTB, the closing agreement(s) will be executed by the Executive Officer of the FTB. The FTB will send to the participant a copy of the fully executed closing agreement(s). However, FTB may reject any submitted closing agreement(s) if the taxpayer fails to satisfy in full the requirements of this Notice prior to the conclusion of the participation period on September 12, 2008. FTB will send notice to the taxpayer of any rejection.

E. Mailing Address. Participants should submit a signed closing agreement, schedules, required information and payment to:

ATSU 398
O Nayebkhil Mail Stop F385
Franchise Tax Board
P O Box 1673
Sacramento CA 95812-9900

For Courier Service Delivery or Private Courier Mail:

ATTN O Nayebkhil ext. #3190
ON ATSU 398 Mail Stop F385
Franchise Tax Board
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The principal author of this notice is Craig L. Scott of the Franchise Tax Board, Legal Division. For further information regarding this notice, contact Mr. Scott at P.O. Box 1720, Rancho Cordova, CA 95741-1720.